No. 11396

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

JAMES H. ADAMSON and MARION C. ADAMSON,

Appellees.

Upon Appeal from the District Court of the United States for the Southern District of California, Central Division

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BRIEF FOR THE UNITED STATES.

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BRIEF FOR THE UNITED STATES.

Opinion Below.

The District Court did not file a written opinion. Its findings of fact and conclusions of law are printed in the Record at pages 79 to 88, inclusive. The basis of the court's decision is shown in the oral statement from the Bench, printed in the Record at page 99.

Jurisdiction.

This appeal involves a suit against the United States for recovery of $2,577.52 alleged to have been erroneously and illegally collected from the taxpayers as federal income tax, interest, and charges for the taxable year 1940. The taxpayers below duly filed a joint return of their income for the year 1940 and after the first installment of $621.29

due thereon was paid with the filing of the return on or about March 14, 1941, they filed a timely claim on or about June 13, 1941, for refund of $540.55 thereof which was rejected by the Commissioner of Internal Revenue on October 5, 1943. [R. 80, 81.] On or about March 10, 1943, taxpayers paid an additional sum of $1,000 on their 1940 income tax liability, and on April 8, 1943, they paid the balance of $867.86 tax shown to be due on their return, plus interest in the sum of $168.11 and $1 for release of a lien. [R. 80.] Thereafter their claim for refund upon which this action is based was filed on or about December 27, 1943, and was rejected on July 26, 1945. [R. 81.] On August 2, 1945, and within the time provided by Section 3772 of the Internal Revenue Code, this action was brought in the District Court for recovery of all but $80.74 of the taxes, interest, and charges so paid for the year 1940. [R. 2-10, 81.] Jurisdiction was conferred on the District Court by Section 24, Fifth, of the Judicial Code. The judgment was entered on January 28, 1946. [R. 89-90.] Within three months thereof, and on March 8, 1946, a notice of appeal was filed [R. 91], pursuant to the provisions of Section 128 (a) of the Judicial Code, as amended.

Question Presented.

Whether the sum of $32,500 received in 1940 by James H. Adamson, one of the taxpayers herein, under the circumstances shown by the Record, constituted ordinary income within the meaning of Section 22 (a) of the Internal Revenue Code, or whether it constituted gain upon the sale of a capital asset within the meaning of Section 117 (a) of the Internal Revenue Code, only 50 per centum of which should be included in taxable income.

Statute Involved.

Internal Revenue Code:

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U. S. C. 1940 ed., Sec. 22.)

Sec. 117. Capital Gains and Losses.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1);

* * * * * * * *

(b) *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized

upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66⅔ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

*   *   *   *   *   *   *   *

(26 U. S. C. 1940 ed., Sec. 117.)

Statement.

This suit was brought by James H. Adamson (herein sometimes called the taxpayer) and his wife, Marian C. Adamson, to recover all but $80.74 which they had paid as federal income tax, interest and charges for the taxable year 1940. [R. 2-6.] The material facts were in large part stipulated [R. 11-78], and were found by the court below substantially as stipulated. [R. 79-88.] The facts are not in dispute.

On or about November 1, 1925, the taxpayer and his brother, Percy Adamson, entered into an agreement to become partners at will under the firm name and style of Adamson Brothers Company for the purpose of engaging in the business of developing and dealing in yarns and textiles, including the development of ideas in the field of special yarns. The taxpayer was to furnish sufficient capital to get started and it was agreed that both would cooperate in the management of the business with the taxpayer exercising general supervision and control and the brother devoting all of his time and attention to the

conduct thereof, the profits to be shared equally between them. The partnership entered upon the transaction of business in November, 1925, and "was terminated on or about the month of December, 1932." [R. 82-83.]

In the year 1930 Percy Adamson conceived the idea of an elastic yarn and, on July 30, 1930, filed application for patent thereon. Between July 30, 1930, and June, 1931, experimental and development work in connection with this idea was conducted and, on June 11, 1931, a new application for patent was filed by Percy Adamson, which was a continuation, in part, of the previous application, and on which a patent was issued on September 9, 1931. [R. 83.] The partnership paid the expense of prosecuting the patent applications and, in addition thereto, incurred liability for development and experimental expenses in connection therewith. At all times prior to November 1, 1931, the invention was dealt with by the taxpayer and his brother as property of the partnership. [R. 83-84.]

The elastic yarn described in the patent issued to Percy Adamson was and is known as "Lastex." On or about April 9, 1931, the partnership filed an application for registration of a trademark for use in connection with the sale of the yarn, which trademark was duly registered on May 8, 1931, as the property of the partnership. [R. 84.]

On or about April 10, 1931, Percy Adamson entered into two written agreements with the Untied States Rubber Company which were superseded by two written agreements entered into by him and the company on or about January 2, 1932, whereby in consideration of the license to use the invention covered by the "Lastex" patent issued to Percy Adamson, and other consideration, including the

agreement of Percy Adamson to procure the assignment to United States Rubber Company of the "Lastex" trade-mark, the company agreed to pay Percy Adamson certain royalties and commissions. [R. 84.] The "Lastex" trade-mark was assigned by the partnership to United States Rubber Company on or about July 7, 1931, pursuant to the agreement of April 10, 1931. [R. 85.]

On or about November 1, 1931, Percy Adamson assumed exclusive management of the partnership affairs of Adamson Brothers Company without the consent of the taxpayer, and on or about March 24, 1934, he repudiated the existence of the partnership or any partnership obligation. [R. 85.]

After November 1, 1931, neither the partnership of Adamson Brothers Company nor the taxpayer engaged in the business of developing or dealing in yarns and textiles, or in the development of ideas in the field of special yarns, nor was the taxpayer engaged in the business of buying or selling inventions or patents. [R. 85.]

On or about May 14, 1934, the taxpayer commenced an action in the Supreme Court of New York County against Percy Adamson for dissolution of the partnership of Adamson Brothers Company and for an accounting of the affairs and property of the partnership. A referee was appointed to hear the action. On December 31, 1937, he rendered his opinion and on January 8, 1938, made his report [R. 21-40, 85-86], which was made the basis of a judgment entered by the court on July 8, 1938. [R. 41-47, 86.] The judgment entered July 8, 1938, among other

things, held in effect that there had been a partnership between the taxpayer and his brother, that the "Lastex" patent and trademark were property of the partnership, and that the taxpayer was entitled to share as a partner in the royalties and commissions paid and to be paid by United States Rubber Company under the agreements of January 2, 1932, with Percy Adamson. In connection with the partnership accounting the court awarded the taxpayer judgment against his brother for $271,044.92 plus interest and costs, and awarded the taxpayer and his brother each an undivided one-half share as a tenant in common in the contracts between Percy Adamson and the United States Rubber Company dated January 2, 1932, and to all payments due or to grow due under the contracts subsequent to September 30, 1937, in the case of the contract covering royalties and subsequent to December 31, 1936, in the case of the contract covering services, except that Percy was entitled to retain a salary of $7,800 per year under the latter contract. [R. 41-47, 86.]

That part of the judgment of July 8, 1938, requiring payment by Percy Adamson to the taxpayer of $271,044.92 plus interest and costs was satisfied prior to the taxable year here involved and is not involved in this proceeding. [R. 96-97.]

Under date of October 20, 1939, and subsequent to the entry of the judgment of July 8, 1938, the taxpayer, his brother, his attorneys to whom he had assigned an interest in the judgment, and the United States Rubber Company entered into a contract [R. 48-78] which gives rise to the

present controversy. Under this agreement the taxpayer sold to Percy Adamson all of his right, title, and interest in and to all assets of the partnership of Adamson Brothers Company, consisting primarily of the "Lastex" patent and trademark and the agreements dated January 2, 1932, between Percy Adamson and the United States Rubber Company. It was stipulated [R. 19], and the court below found [R. 87], that in consideration for the sale Percy Adamson agreed to pay the taxpayer $215,000, without interest, the sum of $5,000 to be paid upon execution of the agreement and the balance to be paid in equal installments of $2,500 each, beginning on December 1, 1939, and thereafter on the first day of each second month until the full amount was paid. The agreement itself, however, a copy of which was made a part of the stipulation [R. 19, 48-60], provided that the $215,000 should be paid to the taxpayer by United States Rubber Company. [R. 58-59.] Furthermore, the agreement of October 20, 1939, does not indicate that the payments in question were to be made on behalf of Percy Adamson, or that they were to be charged to his account by United States Rubber Company.

In any event the taxpayer received payments in 1940, the taxable year here involved, under the contract of October 20, 1939, aggregating $32,500 which he reported in the joint income tax return filed for that year for himself and his wife as income from royalties. [R. 12, 13, 80-81.] This joint return indicated a total tax due of $2,489.15, of which $621.29 was paid with the filing of the return. [R. 80.] Thereafter, and before the balance

of the tax due was paid, the taxpayer filed a claim for refund of $540.55, on the assumption that the total tax due on their joint income for 1940 was $80.74. The ground on which this claim was based was that, "Due to error, profit on sale of patent was included as income from royalties instead of a long term gain." [R. 81-82.] This claim was rejected by the Commissioner of Internal Revenue and therafter the balance of the tax, plus interest and charges, was paid as stated above, and on December 27, 1943, the taxpayer filed a new claim for refund, on which this action is based, in which the ground for refund was stated to be that the taxpayer "erroneously reported a long term gain on the sale of capital assets as income from royalties." The statement accompanying the claim further asserts that the taxpayer sold to his brother, on or about October 20, 1939, "all of his right, title and interest in and to" the partnership of Adamson Brothers Company, and that the profit should be taxed as a capital gain rather than income from royalties. [R. 81-82.]

Upon rejection of the above claim for refund this suit was filed in the court below. [R. 2-6, 11-12, 81.] The court below held, on authority of *Stilgenbauer v. United States,* 115 F. (2d) 283 (C. C. A. 9th), that the taxpayer had, by the agreement of October 20, 1939, sold a capital asset only 50 per cent of which should be reported as income. [R. 88, 99.] Judgment was entered for the taxpayer [R. 89-90], and this appeal followed. [R. 91.]

Statement of Points to Be Urged.

The Government relies upon the following errors as a basis for this appeal [R. 102-103]:

1. The District Court erred in concluding that taxpayers are entitled to judgment against the Government in the sum of $2,577.52, together with interest on that sum at the rate prescribed by law.

2. The District Court erred in that the findings of fact do not support the conclusion of law.

3. The District Court erred in that the findings of fact do not support the judgment.

4. The District Court erred in failing to conclude as a matter of law that the amounts received by the taxpayer in 1940, pursuant to an agreement dated October 20, 1939, whereby James H. Adamson sold to Percy Adamson all of his right, title and interest in and to any and all assets which formerly belonged to the partnership between James H. Adamson and Percy Adamson, under the firm name and style of Adamson Brothers Company, constituted ordinary income for federal tax purposes.

5. The District Court erred in failing to conclude as a matter of law that the income taxes involved in this action were legally and properly assessed and collected.

6. The District Court erred in ordering and entering judgment for taxpayers and in failing to order and enter judgment for the Government.

Summary of Argument.

This is a suit against the United States for a refund of amounts paid as taxes, interest, and charges in which the burden is upon the taxpayer to show he actually overpaid his taxes. This he has failed to do. The basis of his suit is that certain sums which he received during the taxable year represented consideration received upon the sale of "capital assets" as defined in the Internal Revenue Code rather than ordinary income as reported in his tax return. The court below appears to have sustained the taxpayer on the assumption that he sold his interest in a partnership and that such partnership interest was a "capital asset." But this assumption is not justified since the partnership had previously been liquidated and all he actually sold consisted principally of his undivided one-half interest as tenant in common in certain assets which at one time had been partnership property. The evidence does not justify a conclusion that all of the assets transferred were capital assets, nor does it permit any allocation of the payments received between capital assets and the amount received as consideration for the surrender of the taxpayer's right to receive future royalty income. The payments involved were properly reported as ordinary income and the refund sought should be denied.

ARGUMENT.

Amounts Received by Taxpayer Pursuant to the Agreement of October 20, 1939, Are Not Taxable as Capital Gain.

A. Taxpayer Has Failed to Prove He Overpaid His Tax for the Year Involved.

This is a suit against the United States to recover amounts paid as federal income tax, interest, and charges. It is axiomatic that in such an action the burden is upon the taxpayer to prove that he actually has overpaid his taxes. *Lewis v. Reynolds*, 284 U. S. 281, 283. See, also, *Helvering v. Taylor,* 293 U. S. 507, 514, and *Champ Spring Co. v. United States,* 47 F. (2d) 1 (C. C. A. 8th), certiorari denied, 283 U. S. 852.

In this case there is no controversy over the amount of income or profit received in the year 1940 under the contract of October 20, 1939, although there is some doubt as to whether the correct amount has been reported. The principal question is whether the amount received is taxable as ordinary income or as gain from the sale of a capital asset.

The taxpayer's claim here is based upon the ground that the amount involved represents gain from the sale of a capital asset. This places a further burden of proof upon the taxpayer which we submit has not been met.

All income is included generally in gross income under Section 22(a) of the Internal Revenue Code, *supra,* for purposes of the income tax. One of the exceptions to this general rule is contained in Section 117(b) of the Internal Revenue Code, *supra,* which, in so far as this appeal is concerned, provides that only 50 per centum of the gain from the sale of a capital asset shall be included in tax-

able income. The term "capital asset" is defined in Section 117(a) of the Internal Revenue Code, *supra,* as "property held by the taxpayer (whether or not connected with his trade or business)," but does not include stock in trade or other property of a kind which would be included in inventory if on hand at the end of the year, or property held primarily for sale in the ordinary course of his trade or business or property, used in his trade or business, of a character which is subject to the allowance for depreciation. *Cf. Commissioner v. Boeing,* 106 F. (2d) 305 (C. C. A. 9th), certiorari denied, 308 U. S. 619.

The provisions for taxation of capital gains and losses is an exception to the general rule of taxing income and were designed to relieve taxpayers of the excessive burdens otherwise resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions. *Helvering v. N. Y. Trust Co.,* 292 U. S. 455, 466; *Burnet v. Harmel,* 287 U. S. 103, 106; *Kenan v. Commissioner,* 114 F. (2d) 217, 220 (C. C. A. 2d). Like other provisions authorizing deductions, exemptions, credits, and other tax benefits, this provision must be strictly construed. *Helvering v. Northwest Steel Mills,* 311 U. S. 46, 49. Such benefits are granted as a matter of legislative grace, and any person claiming any such benefits must bring himself squarely within the provisions of the statute authorizing such relief or benefits. *Deputy v. du Pont,* 308 U. S. 488, 493; *New Colonial Co. v. Helvering,* 292 U. S. 435, 444; *Helvering v. Northwest Steel Mills, supra.* We submit the taxpayer has not brought himself within the provisions relating to the taxation of capital gains and losses as defined in Section 117(a) of the Internal Revenue Code.

It was stipulated [R. 18-19], and the court below found [R. 87-88], that the taxpayer, his brother (Percy Adamson), and the United States Rubber Company entered into an agreement [R. 48-60], under date of October 20. 1939, under which the taxpayer sold to his brother all of his right, title, and interest "in and to any and all assets which formerly belonged to the partnership" of Adamson Brothers Company for a consideration of $215,-000 to be paid $5,000 upon execution of the agreement and installments of $2,500 on December 1, 1939, and the first of each second month thereafter until the full amount was paid.

The agreement itself, however, states that the taxpayer sold all of his right, title, and interest in, to and under the "certain partnership which formerly existed" between the brothers, "as well as the certain corporation, Adamson Bros. Company, Inc., * * * which later succeeded the said partnership," and the capital stock and obligations thereof, all monies, trade marks, trade names, etc., "which belonged, or belongs," to either the former partnership or to the successor corporation, "which said assets include, or may include, among other things" the "Lastex" patent and trademark and the royalty and service agreements with United States Rubber Company. [R. 52-53.] There is no further indication, either in the agreements of the parties or elsewhere in the record, as to the nature or extent of other assets covered by the sale, or whether such other assets, if any, were "capital assets" within the meaning of Section 117(a), or whether they were held for the length of time required by Section 117(b). To that extent the evidence is insufficient to support the judgment below. *Kessler v. United States,* 124 F. (2d) 152 (C. C. A. 3d); *Lewis v. Reynolds, supra.*

In another respect the taxpayer has failed to prove that he actually overpaid his tax for 1940. The record shows that prior to October 20, 1939, the taxpayer had entered into agreements with the attorneys who represented him in the New York litigation whereby, among other things, he assigned them an interest in the judgment of July 8, 1938, as compensation for services rendered. [R. 61-78.] The attorneys, as parties to the agreement of October 20, 1939, thereunder surrendered all rights which they had in the judgment and relinquished their rights under the earlier agreements with the taxpayer. [R. 54-58.] In consideration therefor the United States Rubber Company (which agreed to pay the taxpayer the $215,000) agreed to pay taxpayer's attorneys the sum of $110,000, without interest, of which $60,000 was to be paid simultaneously with the execution of the agreement and $50,000 to be paid on January 2, 1940. [R. 58.] The stipulation and the findings of the court below are silent with respect to this part of the agreement. But it is apparent from the agreements themselves [R. 48-78] that at least a substantial part of the amount was to be paid to the attorneys in discharge of the taxpayer's obligation to compensate them for services rendered. If this were so, the amount paid to them for that purpose would constitute income to the taxpayer in the year paid. *Old Colonly Tr. Co. v. Commissioner*, 279 U. S. 716; *United States v. Boston & M. R. Co.*, 279 U. S. 732. Neither the stipulation nor the findings indicate whether the payment of $50,000 was made in 1940, but if it was it is apparent that it was not taken into account in determining the taxpayer's liability for that year. [R. 11-12, 80.] If taken into account in determining the taxpayer's liability for the year involved there apparently would be

no refund due him, even on his theory that amounts paid under the agreement represent capital gain. *Cf. Lewis v. Reynolds, supra.* Hence, in this respect the taxpayer is not entitled to judgment on the record. *Cf. Kessler v. United States, supra.*

B. The Amount Involved Is Not Shown to Be Payment for "Capital Assets" Within the Meaning of the Applicable Statutes.

It is clear from the referee's report [R. 21-40], the judgment of July 8, 1938 [R. 41-46], and the testimony [R. 96-97], that when the agreement of October 28, 1939, was entered into the partnership of Adamson Brothers Company had been dissolved and liquidated, the money judgment in taxpayer's favor had been satisfied, and the only vestige of his former partnership interest was an undivided one-half interest as tenant in common in the "Lastex" patent and trademark and an undivided one-half interest as tenant in common in the royalty and service agreements with the United States Rubber Company. Accordingly, if we assume, for purposes of argument, that the taxpayer sold only assets "which formerly belonged to the partnership," consisting of his undivided one-half interest in the assets listed in the stipulation and findings of the court below [R. 19, 87], it still cannot be said that the taxpayer sold an interest in a partnership, as such, and such cases as *Commissioner v. Shapiro,* 125 F. (2d) 532 (C. C. A. 6th); *Thornley v. Commissioner,* 147 F. (2d) 416 (C. C. A. 3d), and *Humphrey v. Commissioner,* 32 B. T. A. 280, whether right or wrong, have no application here.

Considered separately from his interest in the royalty agreements, if we assume that the taxpayer's interest in the patent and trademark represented "capital assets" within the meaning of the statute, still there is nothing in the record to show their cost, if any, and nothing to show what part of the consideration paid or to be paid to the taxpayer under the agreement of October 20, 1939, was applicable to his interest in the patent and trademark. Hence there is nothing to show the gain, if any, applicable to this part of the sale. *Cf. City Bank Farmers Trust Co. v. United States,* 47 F. Supp. 98 (C. Cls); *City Bank Farmers Trust Co. v. United States,* 47 F. Supp. 105 (C. Cls.).

According to the terms of the agreement of October 20, 1939, however, the taxpayer also sold to his brother all of his right, title, and interest in and to the judgment obtained against his brother on July 8, 1938, "and all monies due, and to grow due, thereunder, and the whole, as well as each and every part, thereof." [R. 53.] This judgment [R. 41-46], among other things, awarded the taxpayer the sum of $271,044.92 plus interest and costs. If the money judgment had already been satisfied [R. 96-97], this part of the agreement of October 20, 1939, apparently applied to that part of the judgment fixing the taxpayer's interest in the "Lastex" patents and his right to share in the future income to be derived from the royalty and service agreements with United States Rubber Company, or any such agreements made in the future, plus any amounts accruing subsequent to the period covered by the judgment which may then remain unpaid. To the extent that any part of the consideration received by the taxpayer under the agreement of October 20, 1939, represented consideration for anything conveyed or re-

linquished pursuant to this paragraph it could not constitute payment for a capital asset.

Furthermore, we submit that no part of the payments made or to be made to the taxpayer under the agreement of October 20, 1939, which represented payment for release of his right to receive future income under the royalty and service agreements with the United States Rubber Company can be treated as payment for a "capital asset" within the intendment of the Revenue Acts.

See:

Hort v. Commissioner, 313 U. S. 28;

Helvering v. Smith, 90 F. (2d) 590 (C. C. A. 2d).

The duration or nature of the royalty and service agreements between Percy Adamson and the United States Rubber Company are not disclosed by the record. But if the amount of money judgment awarded the taxpayer as his share of the partnership profits can be taken as a criterion it would seem that a very substantial part, if not all, of the consideration paid or to be paid to the taxpayer under the agreement of October 20, 1939, was paid to secure release of his right to share in the future income to be derived from royalties. Any amounts which the taxpayer was entitled to receive under the royalty and service agreements with the United States Rubber Company would constitute ordinary income, and we know of no authority which would justify holding that consideration received for the release or surrender of that right constitutes proceeds from the sale of a capital asset.

This case, in this respect, does not differ materially from *Helvering v. Smith, supra.* In the latter the tax-

payer, after having been a partner in a law firm for five years, retired and the firm was dissolved. The partnership agreement provided that upon dissolution the majority of those remaining partners should liquidate the firm, and that any retiring partner should not be entitled to any part of any earnings for services performed after dissolution, but should receive in full satisfaction of his interest his proportion of all earnings collected and of all amounts subsequently collected for services already performed. At the time of retiring the taxpayer released his partners from all liability upon dissolution in consideration for a cash payment of $125,000, which was estimated to be the amount that would eventually be due him under the dissolution provisions of the partnership agreement. The Circuit Court of Appeals held that the partnership interest which the taxpayer relinquished was not a capital asset within the meaning of the statute and the amount which he received was a substitute for the right to receive future income.

See, also:

> *Doyle v. Commissioner*, 102 F. (2d) 86 (C. C. A. 4th).

Even more pertinent to the present situation, although not involving any elements of partnership, is *Hort v. Commissioner, supra.* In that case the taxpayer claimed that an amount which he received during the taxable year in consideration for cancellation of a long term lease on property owned by him constituted capital gain. The Supreme Court held that the amount received for surrender of his right to receive future income was taxable as ordinary income. In discussing the capital gains

and losses provisions of the statute, as applicable to circumstances there involved, the Court said (pp. 30-31):

> The amount received by petitioner for cancellation of the lease must be included in his gross income in its entirety. Section 22 (a), copied in the margin, expressly defines gross income to include "gains, profits, and income derived from . . . rent, . . . or gains or profits and income derived from any source whatever." Plainly this definition reached the rent paid prior to cancellation just as it would have embraced subsequent payments if the lease had never been cancelled. It would have included a prepayment of the discounted value of unmatured rental payments whether received at the inception of the lease or at any time thereafter. Similarly, it would have extended to the proceeds of a suit to recover damages had the Irving Trust Co. breached the lease instead of concluding a settlement. Compare *United States v. Safety Car Heating Co.*, 297 U. S. 88; *Burnet v. Sanford,* 282 U. S. 359. That the amount petitioner received resulted from negotiations ending in cancellation of the lease rather than from a suit to enforce it cannot alter the fact that basically the payment was merely a substitute for the rent reserved in the lease. So far as the application of Sec. 22 (a) is concerned, it is immaterial that petitioner chose to accept an amount less than the strict present value of the unmatured rental payments rather than to engage in litigation, possibly uncertain and expensive.
>
> The consideration received for cancellation of the lease was not a return of capital. We assume that the lease was "property," whatever that signifies abstractly. Presumably the bond in *Helvering v. Horst,* 311 U. S. 112, and the lease in *Helvering v.*

Bruun, 309 U. S. 461, were also "property," but the interest coupon in *Horst* and the building in *Bruun* nevertheless were held to constitute items of gross income. Simply because the lease was "property" the amount received for its cancellation was not a return of capital, quite apart from the fact that "property" and "capital" are not necessarily synonymous in the Revenue Act of 1932 or in common usage. Where, as in this case, the disputed amount was essentially a substitute for rental payments which Sec. 22 (a) expressly characterizes as gross income, it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating the right to such payments may be treated as "property" or "capital."

Finally, even if this case be considered as the transfer or assignment of an interest in a defunct partnership we submit the court below erred in holding that the consideration therefor received by the taxpayer constituted payment for "capital assets" within the meaning of the statute.

Beginning with the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, Sec. II D, except for the profits tax imposed under the Revenue Act of March 3, 1917, c. 159, 39 Stat. 1000, Sec. 201, partnerships have not been treated as a separate taxable entity. See *Craik v. United States,* 31 Fed. Supp. 132 (C. Cls.); *Neuberger v. Commissioner,* 311 U. S. 83, and *Commissioner v. Lamont,* 156 F. (2d) 800 (C. C. A. 2d), in which the history of the taxing provisions relating to the taxation of partnership income is discussed at some length. Partnerships have not even been treated as a tax computing entity. *Neuberger v. Commissioner, supra.* The taxing acts

have been based upon the common law conception of joint ownership of property and profits and joint responsibility for partnership obligations. *Helvering v. Smith*, 90 F. (2d) 590 (C. C. A. 2d.) Accordingly, instead of taxing partnerships the individual partners have been made liable for their distributive share of partnership profits and losses.

Many cases have been decided in which this principle of taxation has been applied to gains or losses realized by individuals as a result of shifting or termination of partnership interest, distribution of partnership assets, or liquidation of the partnership. The position taken by the Commissioner with respect to the application of the capital gains and losses provisions of the statute to many such transactions is illustrated in Sol. Op. 42, 3 Cum. Bull. 61 (1920), G. C. M. 10092, XI-1 Cum. Bull. 114 (1932); G. C. M. 11557, XII-1 Cum. Bull. 128 (1933), and G. C. M. 20251, 1938-2 Cum. Bull. 169.

The majority of cases involving application of the taxing provisions of the statute to rearrangement, termination, or disposition of the partnership interest fall generally into one of three groups. One such group involves application of the provisions to cases where the partnership has sold capital assets and the proceeds have been paid to a partner or held to his credit by the partnership. In such cases the courts seem to have uniformly applied the joint ownership and joint obligation theory rather than any theory of separate entity. Representative of

this group are cases like *United States v. Coulby,* 251 Fed. 982 (N. D. Ohio), affirmed, 258 Fed. 27 (C. C. A. 6th); *Central Hanover Bank & Trust Co. v. United States,* 35 F. Supp. 764 (C. Cls.); *Neuberger v. Commissioner, supra,* and *Craik v. United States, supra.* See also, *Helvering v. Walbridge,* 70 F. (2d) 683 (C. C. A. 2d), *certiorari* denied, 293 U. S. 594.

A second group of such cases involves application of the taxing provisions where capital assets are transferred from the partnership to a partner and sold by him. In such cases the courts also seem to have followed the co-ownership theory rather than any theory of separate entity in holding that gain or loss is not recognized at the time of distribution. Cf. *Munson v. Commissioner,* 100 F. (2d) 363 (C. C. A. 2d); *Crawford v. Commissioner,* 39 B. T. A. 521; *McClellan v. Commissioner,* 42 B. T. A. 124, affirmed, 117 F. (2d) 988 (C. C. A. 2d). This was the substance of what took place in *Stilgenbauer v. United States,* 115 F. (2d) 283, decided by this Court, and upon authority of which the decision below purports to have been based. [R. 99.]

The third group are cases where the partner has disposed of his entire interest in the partnership. But with the exception of the *Shapiro, Thornley,* and *Humphrey* cases cited above, and *Hill v. Commissioner,* 38 F. (2d) 165 (C. C. A. 1st), the authorities seem to require determination of the tax liability involved on the theory of co-ownership of assets rather than upon any theory

of separate entity. Cf. *Harris v. Commissioner,* 39 F. (2d) 546 (C. C. A. 2d); *Rossmore v. Commissioner,* 76 F. (2d) 520 (C. C. A. 2d); *Jennings v. Commissioner,* 110 F. (2d) 945 (C. C. A. 5th), *certiorari* denied, 311 U. S. 904; *Benjamin v. Hoey,* 135 F. (2d) 945 (C. C. A. 2d); *Williams v. McGowan,* 152 F. (2d) 570 (C. C. A. 2d); *City Bank Farmers Trust Co. v. United States,* 47 Fed. Supp. 98 (C. Cls.); *Munson v. Commissioner, supra; Helvering v. Smith, supra.*

In basing its decision upon the decision of this Court in *Stilgenbauer v. United States, supra,* we submit the court below completely misconstrued the *Stilgenbauer* opinion. In its statement the court below said [R. 99]:

> That decision holds that any method of terminating the partnership, whether it be by mutual agreement dissolving the partnership and a withdrawal of capital by one partner, or whether it be sold to outsiders, or whether it be by the legal process of dissolution, any one of these is treated by the Ninth Circuit as a sale, and taxable as capital loss or gain, and not as income.

We submit neither the *Stilgenbauer* case nor any other case stands for this broad proposition. In the *Stilgenbauer* case, page 285, the taxpayer, for a money consideration, transferred to his two partners "all his right, title and interest in and to the specific partnership property." The court pointed out that under California law two other methods of disposing of his partnership interest were available to him. As to the tax consequence, if he had adopted a different method the court said (p. 287) the fact that there is involved the same value to the retiring partner "does not make one taxable process nontaxable because another, nontaxable, is not chosen." In

that case the Commissioner determined the taxpayer's co-ownership interest in specific partnership property to be capital assets and his decision in this respect was sustained.

While the New York law with respect to the rights of partners is the same as that of California *(Helvering v. Smith, supra)*, the situation in the instant case is materially different. Here the partnership had been dissolved. All the taxpayer retained at the time of the sale was an undivided one-half interest as tenant in common in certain property which had been property of the former partnership. As pointed out above, it has not been shown that the consideration received by the taxpayer was paid to him as consideration for the sale of capital assets as defined by the statute. He properly reported such payments as ordinary income and the refund should be denied.

Conclusion.

The decision below is wrong. It is contrary to the facts and the law and should be reversed.

Respectfully submitted,

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